MULTIMEDIA UNIVERSITY

STUDENT IDENTIFICATION NO

MULTIMEDIA UNIVERSITY

FINAL EXAMINATION

TRIMESTER 1, 2020/ 2021

BAC3624 – ADVANCED AUDITING

(All Sections / Groups)

19 OCTOBER 2020
9.00 a.m. – 12.00 p.m.
(3 Hours)

INSTRUCTIONS TO STUDENTS

1. This Question paper consists of 7 pages excluding cover page with **5** questions only.

2. Attempt ALL questions. The distribution of the marks for each question is given.

3. Write all your answers in the Answer Booklet provided.

QUESTION 1

a) The managing director of Tata Sdn. Bhd. (Tata), an external audit client of your firm, has discovered that a warehouse manager made fictitious entries in Tata's inventory records to conceal the misappropriation of inventory costing RM25,000. The managing director discovered the fraud as a result of an inventory count at which your firm was not present. He has contacted your firm to express his concern that the audit team did not discover this fraud during the external audit. The financial statements for the current year show revenue of RM10 million and profit before tax of RM1.5 million.

Explain why the managing director's expectation that the audit team should have discovered the fraud is unrealistic.

(4 marks)

b) Explain the benefit of the mandatory rotation of the appointment of audit firms.

(3 marks)

c) During the external audit of Babolat Sdn. Bhd. (Babolat) for the year ended 31 January 2020, you discover a letter to Babolat dated 15 February 2020 from its largest customer, Axa Sdn. Bhd. (Axa). The letter threatens the early termination of Axa's contract with Babolat due to issues over the quality of goods supplied.

Explain the relevance of this letter to the external audit of Babolat for the year ended 31 January 2020.

(3 marks)

d) Your firm is the external auditor of Chanel Bhd (Chanel), a large listed entity. The directors of Chanel have requested that your firm undertakes an additional engagement to value the company's investments for inclusion in the financial statements for the year ending 31 March 2020. Chanel's investments are material proportion of the company's total assets. State, with reasons, how your firm should respond to this request.

(3 marks)

e) Explain the fundamental principle of professional competence and due care and provide two (2) examples of how an audit firm can identify whether its partners and staff are complying with this principle.

(4 marks)

f) Explain the limitations of using analytical procedures at the planning stage of an external audit.

(3 marks)

(Total: 20 marks)

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QUESTION 2

Your firm has recently been appointed as the external auditor of Global Berhad (Global). Global has developed Saga, an online human capital management system, which includes payroll processing, employee expense management and time tracking tools. Global contracts with corporate customers to supply access to Saga over the internet. You are the audit senior responsible for planning the external audit for the year ended 31 January 2021. The engagement partner has asked you to consider the following key areas of audit risk:

(1) Revenue – user license fees and set-up fees
(2) Intangible assets – software development costs
(3) Compensation payable and receivable

Global charges customers an annual license fee for Saga based on the number of expected users within the customer's organisation. A user is any person at the customer's organisation that has access to Saga. The expected full license fee is payable by the customers at the start of each 12-month period covered by the contract. At the end of each 12-month period, Global compares the number of actual users who have accessed Saga with the expected number of users to determine any over- or under- usage by the customer. Customers pay additional license fees to Global for over-usage and Global refunds customers for any under-usage. Global recognises revenue from license fees evenly over each 12-month contract period. Revenue is adjusted for any anticipated over- or under-usage on contracts straddling the year end.

New customers are charged a fixed set-up fee, which must be paid before work commences on setting up Saga for the organisation. Set-up takes between three and nine months to complete. On completion of the set-up, customers are required to confirm in writing that Saga has been satisfactorily set up. Set-up fees are recognised evenly over the set-up period. Global has a reputation in the market for making continuous improvements to Saga. Global's software developers make changes to Saga in order to fix software problems (bugs), make improvements and release new features. Developers keep a record of the time spent working on each change. Each month, Global's head of development uses these time records to calculate the amount of developers' costs relating to improvements and new features. These software development costs are capitalised and amortised over their estimated useful lives. Amortisation and developers' costs incurred to fix bugs are included in cost of sales.

Contracts between Global and its customers require Saga to be available to users for 99.5% of the time. Global must pay compensation to its customers, at the rate agreed in each contract, for each month in which the 99.5% service level is not met. In January 2021, Global did not meet the 99.5% service level due to a failure at the data centre where Saga is hosted. The data centre is owned and operated by IBO Sdn Bhd (IBO). Global intends to claim compensation, under its contract with IBO, for the costs incurred as a result of the failure at the data centre. Global's directors have estimated that the

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compensation due to its customers in respect of this failure is RM920,000. No amounts for compensation payable or receivable have been included in the draft financial statements as the directors expect the compensation to be claimed from IBO to exceed the amount due to Global's customers.

You have obtained the following information from Global's management to use in your consideration of the key areas of audit risk:

Year ended 31 January:	**2021**	**2020**
Average number of Saga users	627,546	572,158
New customers	49	63

Statement of profit or loss for the year ended 31 January (extract)

	2021 (draft) RM'000	**2020 (audited)** RM'000
Revenue		
Saga user license fees	58,187	42,198
Set-up fees	11,997	12,480
	70,184	54,678
Cost of sales (note)	(35,051)	(34,454)
Gross profit	35,133	20,224

Note: Cost of sales for the year ended 31 January 2021 includes costs of RM899,000 incurred in fixing bugs (year ended 31 January 2020: RM1,678,000).

Extract from notes: Intangible assets – software development costs

	2021 (draft) RM'000	**2020 (audited)** RM'000
Carrying amount at 1 February	8,745	10,163
Additions	5,791	3,417
Amortisation in the year	(4,124)	(4,835)
Carrying amount at 31 January	10,412	8,745

Required:

(i) Justify why the items (1-3) listed by the engagement partner have been identified as key areas of audit risk and, for each item, describe the procedures that should be included in the audit plan to address those risks.

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You should present your answer using the following subheadings:

(a) Revenue – user license fees
(b) Revenue – set-up fees
(c) Intangible assets – software development costs
(d) Compensation payable and receivable

(30 marks)

(ii) Companies, such as Global, have a responsibility to put measures in place to protect their customers from loss of data and breaches of data security. Identify and explain the audit risks that would arise if Global failed to meet these responsibilities.

(5 marks)

(Total: 35 marks)

QUESTION 3

Your firm was recently appointed as the external auditor of Best Car Components Sdn. Bhd. (BCC) for the year ended 31 December 2020. BCC is a manufacturer of car components and has two factories in Malaysia, in Ipoh and Johor.

During the audit of the financial statements for the year ended 31 December 2020, the following issues in relation to inventories were identified:

(a) Goods received in the Ipoh factory are not checked prior to being accepted.

(b) With respect to the storage of materials prior to their use in the manufacturing of car components at Johor factory:
- Gold and platinum used in the manufacture of catalytic converters are not stored securely; and
- Poisonous chemicals used in the manufacture of car batteries are kept in open tanks in an area of the factory with unrestricted access.

Required:

i. Define internal controls. (2 marks)

ii. External auditors are required to communicate significant deficiencies in internal controls identified during the audit to those charged with governance. Identify and explain the attributes that such communications should have to be effective.

(4 marks)

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iii. With respect to the internal control deficiencies described above, draft points for inclusion in your firm's report to those charged with governance and management of BCC. For each deficiency, you should outline the possible consequence(s) of the deficiency and provide recommendations to address them.

(8 marks)

(Total: 14 marks)

QUESTION 4

Described below are four situations, which have arisen at four unrelated audit clients of your firm. The year end for each client is 31 August 2019.

(a) Daston Sdn. Bhd. (Daston)

During the external audit for the year ended 31 August 2019, your firm reviewed Daston's board minutes. The August board minutes noted that Japlin Sdn. Bhd. (Japlin), Daston's largest customer, had written to inform Daston that it would not be renewing its contract with Daston. The contract with Japlin makes up 80% of Daston's business and the current contract is due to expire on 31 December 2019.

As part of the evaluation of management's assessment of Daston's ability to continue as a going concern, your firm examined Daston's cash flow forecast for the period ended 31 December 2020.

(b) Noody Sdn. Bhd. (Noody)

During the external audit for the year ended 31 August 2019, your firm performed audit procedures on Noody's supplier statement reconciliations. One reconciliation, in respect of amounts due to Debbie Bhd (Debbie), showed a reconciling item of RM127,000. This amount was paid by Noody on 27 August 2019. However, in error this was paid to a bank account, which did not belong to Debbie.

The error occurred because Noody's purchase ledger clerk used new bank account details provided in an email purporting to be from Debbie's sales ledger clerk. After the payment was made, the purchase ledger clerk discovered the email was not genuine and had been sent by a fraudster. Noody's financial controller believes Noody has no further liability to Debbie as the fraud was not Noody's fault. The balance of RM127,000 is not included in Noody's trade payables at 31 August 2019. Noody's draft financial statements for the year ended 31 August 2019 showed a profit before tax of RM840,000.

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(c) Genoa Bhd. (Genoa)

Your firm has completed an engagement to review and provide an assurance report on Genoa's consolidated financial statements. This assurance engagement was requested by Genoa's directors to support the acquisition of funding to grow the business. Genoa has recently acquired a subsidiary Milan Sdn. Bhd. (Milan). Genoa has not consolidated the financial statements of Milan but has included it as an investment, at cost, in the consolidated financial statements. This accounting treatment is not in compliance with the Malaysian Financial Reporting Standards. Had Milan been consolidated, many elements in the financial statements would have been materially affected.

(d) Florence Sdn. Bhd. (Florence)

The management of Florence has refused to provide your firm with written representations regarding its responsibility for the preparation of the financial statements or the completeness of recorded transactions and information provided during the audit.

Required:

(i) For each of the four situations above, state with reasons, the implications for your firm's audit or assurance report.

(12 marks)

(ii) List the differences between a report prepared by a practitioner for an engagement to review financial statements and the report prepared by auditors for an external audit engagement of an unlisted company.

(4 marks)

(Total: 16 marks)

QUESTION 5

El-Rummy & Co (EL), a medium-sized audit and assurance firm, provides services to listed clients. EL's two largest clients are Venice Bhd (Venice) and Rome Bhd (Rome) from which EL earns the following fee income:

	Venice RM'000	**Rome RM'000**
Annual external audit	920	880
Annual tax services	575	550
One-off engagements	560	145
Total	**2,055**	**1,575**

EL's total annual fee income, including fees from Venice and Rome, is RM16 million. EL's other clients generate a total annual fee income of less than RM1 million each. EL is currently completing the external audits of Venice's and Rome's financial statements.

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Venice's financial statements and auditor's report, for the year ended 31 July 2020, are due to be signed on 12 September 2020. However, audit procedures have identified a number of internal control issues relating to new accounting software implemented by Venice during the year. The engagement partner, Mr Abu Samah, has advised the directors of Venice that the auditor's report will not be signed before 30 September 2020, to allow time for additional audit procedures. Venice's directors have responded that the signing of the auditor's report cannot be delayed. This is because Venice is required to present its audited financial statements to its bank, on 13 September 2020, in support of a loan application. Venice's directors have stated that any delay will result in your firm not being reappointed as external auditor at Venice's next annual general meeting. Abu Samah was unaware that Venice's bank had requested the audited financial statements.

The financial controller of Rome left the company suddenly during the course of the audit. The directors of Rome have offered the role of financial controller to the audit manager who has informed the engagement partner that he intends to accept the offer.

Required:

(i) Set out EL's responsibilities if it is not reappointed as external auditor at Venice's next annual general meeting.

(2 marks)

(ii) Identify and explain the significant matters arising, including any professional and ethical issues, in relation to the services provided to Venice and Rome. State any steps EL should take to address those matters.

(13 marks)

(Total: 15 marks)

End of Paper